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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. ———

FEDERAL POWER COMMISSION, PETITIONER

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Federal Power Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case entered on February 10, 1966.

OPINIONS BELOW

The opinion of the court of appeals (App A, *infra*, pp. 18–20) is reported at 357 F. 2d 230. The opinion and order of the Federal Power Commission are reported at 31 F.P.C. 1180 (II R. 32–55; see II R. 41–42, 31 F.P.C. at 1190–1191, for the relevant portions). The Commission's decisions on the applications for rehearing are reported at 32 F.P.C. 687, 879, and 1163.

JURISDICTION

The judgment of the court of appeals setting aside the Commission's order was entered on February 10, 1966 (App. B, *infra*, pp. 21–22). We invoke the jurisdiction of this Court under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether, in fixing the rates charged by a natural gas company, the Federal Power Commission must allow as a cost of service the amount of federal income taxes the company would have paid if it had filed a separate tax return, when in fact it filed a consolidated return with affiliated corporations (not all the operations of which are subject to the Commission's regulatory jurisdiction), resulting in a net tax savings for the group of affiliates.

STATUTES INVOLVED

The Natural Gas Act, June 21, 1938, c. 556, 52 Stat. 821–833, as amended, 15 U.S.C. 717–717w, provides in pertinent part:

> SEC. 4. (d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. * * *

(e) Whenever any such new schedule is filed the Commission shall have authority * * * to enter upon a hearing concerning the lawfulness of such rate * * *. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company * * *.

The Internal Revenue Code of 1954, 68A Stat. 3, *et seq.*, as amended, 26 U.S.C. 1–8023, provides in pertinent part:

§ 1501. Privilege to file consolidated returns

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

* * * * *

§ 1504. Definitions

(a) Definitions of "affiliated group".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

* * * * *

STATEMENT

1. THE FACTS

United Gas Pipeline Company (United) is a major interstate natural gas pipeline company subject to the jurisdiction of the Federal Power Commission.[1] It is a wholly owned subsidiary of United Gas Corporation (Gas Corporation). The latter's principal business is the operation of several local gas distribution systems (which are subject to State and municipal rate regulation) in Texas, Louisiana and Mississippi. Gas Corporation also owns all the stock of Union Producing Company (Union), a domestic producer of oil and gas whose interstate gas sales are subject to Federal Power Commission regulation, and United Overseas Production Corporation, which is engaged in foreign oil exploration.

[1] Approximately 44 percent of United's sales are within the rate jurisdiction of the Commission (R. 54).

Union, United and Gas Corporation constitute an integrated gas utility system from wellhead to consumer's premises, with Union selling approximately 80 percent of the gas it produces to United and United furnishing Gas Corporation (the distributing arm of the system) with approximately 96 percent of the latter's gas.[2] With gross revenues in 1961 of $298 million, United is by far the largest company in the system; in the same year, Gas Corporation's gross operating revenues were $50 million and Union's $52 million.[3]

Gas Corporation and its wholly owned subsidiaries, including United, file (pursuant to Section 1501 of the Internal Revenue Code of 1954, see p. 3, *supra*) consolidated federal income tax returns in which the taxable transactions of the four members of the affiliated group are combined to produce a single net taxable income, upon which the tax is computed. Any tax losses sustained during the taxable period by a member of the group are offset against the taxable income of the profit companies for the same period in determining the consolidated net taxable income, and income and expense items resulting from transactions among the affiliates are excluded in computing the taxable income of the consolidated group.[4]

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[2] *Union Producing Co.*, 31 F.P.C. 41, 43–44; 1964 Annual Report of United Gas Corporation, p. 4 (on file with FPC).

[3] Moody's Public Utility Manual (1962), p. 1368.

[4] Thus, dividends paid by affiliates are excluded from the income of the receiving company; and interest paid to affiliates is treated as income to the receiving company and a deduction to the paying company, and so cancel out (R. 93).

Between 1957 and 1961, the group, filing consolidated returns, paid $57,199,881 to the government in income (excluding capital-gains) taxes (R. 53). Had separate returns been filed, the total tax for the four companies for the same period (excluding the taxes that would have been paid on inter-company dividends)[5] would have been $59,291,919. The difference reflects the fact that in the consolidated returns the group was able to set off Union's net tax losses of $3,869,626, and the $24,434 loss of Overseas (which commenced operations in 1961, see R. 24), against the income of United and Gas Corporation.

2. PROCEEDINGS BELOW

On June 15, 1962, United,[6] pursuant to Section 4(d) of the Natural Gas Act (p. 2, *supra*), filed revised schedules with the Federal Power Commission increasing its rates overall. The Commission ordered a hearing to determine the lawfulness of the increased

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[5] Prior to 1964, 15 percent of all dividends received by corporations were taxable as ordinary income, so that where inter-affiliate dividends were large the tax savings to the consolidated group in this respect alone were substantial. During the five-year period, Gas Corporation received $66,567,028 in dividends from United and Union, on which a tax of about $5 million would have been due had separate returns been filed. Section 214 of the Revenue Act of 1964 permits the exclusion of 100 percent of dividends received from 80-percent-owned affiliates. 78 Stat. 52, 26 U.S.C. 243.

[6] The other respondents in this Court are pipeline customers of United that intervened before the Commission and participated in the review proceeding in the court of appeals, opposing this reduction in United's rates. They each join with their affiliates in filing consolidated tax returns.

rates, and, in its decision of May 14, 1964 (31 F.P.C. 1180, II R. 32), made the reduction here involved. In petitioning for review below United objected to this and other aspects of the Commission's order, but, by the time the case was decided, only one issue remained: whether the Commission could test the reasonableness of United's rates against its cost of service without including in such cost the full amount of federal income taxes United would pay if it paid at the standard rate for corporate taxpayers filing separate returns, when, in fact, United joins in consolidated returns that produce substantial savings.

The Commission's approach was as follows. Applying principles that it had recently enunciated in its *Cities Service* decision, 30 F.P.C. 158, later set aside in *Cities Service Gas Co.* v. *Federal Power Commission,* 337 F. 2d 97 (App. C, pp. 23–30, *infra*), it held (II R. 41–42) that, in order fairly to apportion the joint federal income tax costs, "the fundamental rate making principle" that "requires a separation between regulated and unregulated costs and revenues" should be recognized (30 F.P.C. at 162). To this end it (1) separated the affiliated corporations into regulated and unregulated groups; (2) determined the net taxable income (after deducting any losses) of each group; and (3) apportioned the total consolidated tax liability over a representative period of time between the two groups, and then among the companies in the regulated group, in proportion to their

respective taxable incomes (II R. 41).[7] This meant that any losses sustained by any unregulated company or activity would first be set off against the total income of all the unregulated operations. Since, however, here the unregulated activities produced no net taxable income during the five-year period 1957–1961 (used by the Commission as a representative test period), this preliminary step became unnecessary. The consolidated tax actually paid by the system during the test period was simply allocated between the two profit companies, Gas Corporation and United, in proportion to their taxable incomes (excluding capital gains) for the five years—$9,024,170 and $105,290,983, respectively.

United's income was 92.11 percent of the total. This percentage was multiplied by the system's average annual tax of $11,439,976 during the test period, producing a sum ($10,537,362) deemed by the Commission to be United's fair share of the tax. This sum represented 50.04 percent of United's average annual taxable income of $21,058,197. It was this effective tax rate—not the 52-percent rate at which United would have paid federal income tax had it filed a separate return—that the Commission used to determine United's test-year tax allowance for rate purposes (II R. 41, 42 53).

United contended that it was entitled to compute its tax allowance for rate-making purposes at the

[7] The Commission added that in no event should "the allowance so computed for the regulated company * * * exceed what its tax liability would be for rate making purposes, if computed on a separate return basis." (30 F.P.C. at 164.)

separate-return rate, and the court of appeals agreed. In a brief opinion (App. A, *infra*, pp. 18–20) it adopted the reasoning on this issue of the Tenth Circuit in *Cities Service Gas Co.* v. *Federal Power Commission*, 337 F. 2d 97 (printed in App. C, *infra*, pp. 23–30). Neither court addressed itself to the particulars of the Commission's allocation method—the three-step procedure described above. Both apparently concluded that the Commission was powerless to make any allocation and that United was entitled to have federal income tax included in the cost of service used to test the reasonableness of its rates at the full 52-percent rate for separate corporate returns.

REASONS FOR GRANTING THE WRIT

Taxes incurred by a public utility are normally treated as a part of its cost of service against which the reasonableness of its rates is tested. In the present case the utility (a natural-gas pipeline company regulated by the Federal Power Commission) did not file a separate federal income tax return. Rather, it filed a consolidated return as part of a group of affiliated corporations. While United (the respondent pipeline company) had taxable income, some of the other members of the group—companies engaged in oil and gas production—did not. The filing of consolidated returns permitted the tax losses of the producing companies to be offset against United's income, resulting in a smaller tax for the group than if each member had filed a separate return. United claimed, however, that it was entitled to include in its cost of service a tax allowance equal to the larger tax that

it would have paid had it filed separately—this on the theory that no part of the tax saving due to the consolidated filing should be attributed to it. The court below, following an earlier decision of the Tenth Circuit (*Cities Service Gas Co.* v. *Federal Power Commission*, 337 F. 2d 97, App. C, *infra*, pp. 23–30), upheld this contention, denying that the Commission has any power to compel an allocation of the tax saving. We believe that this ruling is erroneous and that the question is in all events one of substantial importance in the administration of the Commission's rate-making responsibilities.

1. We emphasize at the outset the breadth of the ruling below. The court of appeals did not criticize the particular allocation formula applied by the Commission (see Statement, *supra*, pp. 7–8); it apparently held that the Commission is powerless to allocate under *any* formula—at least in a case like the present where some of the activities of the consolidated group that give rise to the tax losses are outside the regulatory regime of the Commission.[8] The court of appeals' view would have considerable force if there were no rational connection between the regulated and

[8] There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group. These problems need not be faced here, however, since, as noted in the text, the disagreement of the court below was not with the details of the allocation method but with the principle that allocation is under any method permissible.

unregulated activities of the consolidated group whose tax saving the Commission sought to allocate. But there clearly is such a connection.

It is axiomatic that there can be no tax savings without profits. A tax loss does not in itself automatically give rise to a benefit; that occurs only when there are profits against which to offset the loss. In the present case, the regulated companies in the affiliated group—United (the pipeline company) and Gas Corporation (the distributing company)—supplied the profits that permitted the producing companies' losses to be turned into an immediate tax saving for the consolidated group.[9] In this connection, it is highly material that, as regulated quasi-monopolistic utilities, respondent and Gas Corporation have virtually assured profit positions. An affiliated group of corporations that includes a pipeline of United's magnitude is virtually certain to have a steady source of profits against which to offset losses from other ventures—a factor which guarantees that any tax losses will give rise to tax savings and furnishes a substantial cushion against entrepreneurial risks. Thus, it is clear that any tax savings that result from the consolidated computation are at least partly at-

[9] A tax loss of a corporation filing a separate return can only be carried back three years or forward five (26 U.S.C. 172); it cannot be offset against the income of another corporation. Hence, where separate returns are filed, the reaping of any tax benefit from a loss depends on the existence of profits adequate to absorb the loss within the prescribed time limits; where consolidated returns are filed, tax losses may be translated immediately into tax savings irrespective of the past or future profitability of the tax loss company.

tributable to the fully regulated members of the group.[10]

As one would expect in a closely integrated system, the pipeline and distribution companies contribute importantly to the production arm of the business in other respects as well. A large and profitable system can raise capital on favorable terms.[11] Moreover, in a vertically integrated enterprise, the production company has an assured market. Here, of course, there was the further assurance that Union's rates to United would be fixed so as to cover its cost of service, including a fair return on investment (unless its costs proved so excessive as to be improvident). These costs would therefore be borne ultimately by United's customers. It is thus wholly unrealistic to attribute tax savings dependent upon tax losses sustained by the members of the group engaged in unregulated activities solely to those members, ignoring the important contribution made by the fully regulated members—and their customers. Such tax savings should be regarded as reducing the joint tax costs

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[10] In addition, of course, respondent's participation in the joint return filed by the group was an inescapable statutory prerequisite to any of its members' taking advantage of the consolidated tax treatment provided by Section 1501 of the Internal Revenue Code. For, under that section, in order for an affiliated group of companies to qualify to file a consolidated return every subsidiary in which the parent owns 80 percent or more of the stock must join.

[11] Union's entire capital was furnished by Gas Corporation. *Union Producing Co.*, 31 F.P.C. 41, 47. The problems and risks for an unaffiliated producer are greater. See discussion in *Southern Natural Gas Co.*, 29 F.P.C. 323, 336.

of the consolidated group and, like any other reduction in joint costs, allocated among the members of the group by an appropriate method. Compare *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581.

2. The view of the court below—that the Commission lacks power to allocate, for rate-making purposes, the tax savings generated by the filing of a consolidated return—finds no support in the policy underlying the relevant provisions of the Internal Revenue Code. The purpose of permitting the filing of a consolidated return is not to confer a benefit upon the loss company alone—the result reached below—but to recognize the business reality that affiliated corporations constitute a single entity no less than if the affiliates were divisions of a single corporation. See S. Rep. No. 960, 70th Cong., 1st Sess., p. 14; H. Rep. No. 704, 73d Cong., 2d Sess., p. 17; *Erie Lighting Co.* v. *Commissioner of Internal Revenue*, 93 F. 2d 883, 884–885 (C.A. 1). There is no indication that Congress, by thus permitting the corporate form to be disregarded for some tax purposes, proposed to preclude allocation of the resulting tax savings among the members of the consolidated group; all indications, indeed, are to the contrary.[12]

As a matter of fact, the Commission has long offset the tax losses of a natural gas pipeline company's production department resulting from its gas opera-

[12] "* * * The Code and Regulations recognize that the benefit of consolidated returns is for all corporations in the group. Any subsidiary in the group, as well as the parent, may pre-

tions against the larger tax liability that would otherwise have been incurred by the pipeline company as a result of its profitable transmission operations. See, *e.g.*, *El Paso Natural Gas Co.* v. *Federal Power Commission*, 281 F. 2d 567, 571–573 (C.A. 5), certiorari denied *sub nom. California* v. *Federal Power Commission*, 366 U.S. 912. Respondent has not challenged this principle. But if that is sound, surely it would be anomalous, and contrary to the scheme of the relevant Code provisions, for the pipeline company to be able to achieve different treatment merely by incorporating the production department as a separate subsidiary.

3. Since the Court of Appeals for the Tenth Circuit has adopted the same view as the court below (*Cities Service Gas Co.* v. *Federal Power Commission*, *supra*), and since so many of the principal companies subject to the Commission's rate juris-

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vent the filing of consolidated returns if the filing is detrimental or contrary to the interests of such corporation. * * *

* * * * *

"There is nothing in the Code or Regulations that compels the conclusion that a tax saving must or should inure to the benefit of the parent company or of the company which has sustained the loss that makes possible the tax saving." *Western Pacific R.R. Corp.* v. *Western Pacific R. Co.*, 197 F. 2d 994, 1003–1004 (C.A. 9), reversed on procedural grounds, 345 U.S. 247, but see Justice Jackson, dissenting, who would have affirmed on the merits, 345 U.S. at 277.

Cf. Section 1552 of the Internal Revenue Code, which prescribes a number of alternative methods of allocating the consolidated tax among the members for earnings and profits purposes.

diction are able to invoke the reviewing jurisdiction of at least one of these two courts of appeals, the decision below, unless reversed, will, as a practical matter, prove conclusive for the entire industry.

The issue is undeniably a very substantial one from the standpoint of the nation's consumers of natural gas. Of the 77 pipeline companies having annual utility operating revenues of $1 million or more, 39 reported to the Commission in 1964 that they participated in consolidated returns; presumably the motive in each case was tax savings. Each such instance raises the question whether the consumer shall share in these savings or whether he shall be required to pay rates which reimburse the pipeline company as if such savings had not been effectuated.

In addition, the question presented by this case has ramifications throughout the field of public utility regulation. Thus, the principles of this case appear fully applicable to electric companies regulated by the Commission under the Federal Power Act, 16 U.S.C. 791a–825r. Sixty-one of the major electric utilities reported to the Commission in 1964 that they participated in the filing of consolidated returns. The same issue involved in the present case arises under Part II of the Communications Act of 1934, 47 U.S.C. 201–222; it has been the practice of the FCC to take into account any tax savings resulting from the filing of consolidated returns in computing a regulated carrier's tax allowance. *Investigation of Rates and Charges to West Indies,* 10 F.C.C. 33, 51–53; see, also, *Western*

Union Telegraph Company, 25 F.C.C. 532, 648, Table A, n. 2. There are also numerous decisions by State courts and commissions dealing with the federal income tax component to be utilized in determining the rates of telephone, water, electric, gas, and other utilities filing consolidated returns with other companies,[13] and while a decision by this Court in the present case would not bind the State authorities it would undoubtedly be influential.

The problem, in short, is one of major concern in the regulatory community, and its resolution will affect by many millions of dollars the rates to be paid by members of the public for various types of utility service.

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[13] See, *e.g.*, *Arkansas-Louisiana Gas Co.* v. *City of Texarkana, Ark.*, 17 F. Supp. 447 (W.D. Ark.); *Re Southwestern Bell Telephone Company*, 2 P.U.R. 3d 1, 17 (Ark.); *Re Chesapeake & Potomac Telephone Company*, 6 P.U.R. 3d 222, 242–244 (D.C.); *Re United Fuel Gas Company*, 8 P.U.R. 3d 340, 346–347 (Ky.); *Re Chesapeake & Potomac Telephone Company of Baltimore City*, 5 P.U.R. 3d 161, 166–168 (Md.); *Re New Jersey Bell Telephone Company*, Docket No. 7519, XVIII Reports of the New Jersey Board of P.U.C. 562; *Re New Jersey Bell Telephone Company*, 24 P.U.R. 3d 181, 195 (N.J.); *Re Northwestern Bell Telephone Company*, 2 P.U.R. 3d 93, 95 (N. Dak.); *Riverton Consolidated Water Company* v. *Pennsylvania Public Utility Commission*, 24 P.U.R. 3d 9, 20–21 (Pa. Super. Ct.).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

THURGOOD MARSHALL,
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Federal Power Commission.

MAY 1966.

APPENDIX A

In The United States Court of Appeals for the Fifth Circuit

No. 21872

UNITED GAS PIPE LINE COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

No. 21958

UNITED GAS PIPE LINE COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL POWER COMMISSION.

(February 10, 1966)

Before JONES, WISDOM and GEWIN, *Circuit Judges.*

Per Curiam: Before the Court for its consideration

are four petitions for review of orders of the Federal Power Commission which present the same rather narrow but difficult question for determination. The Petitioner United Gas Pipe Line Company is a natural gas transmission company. It is a member of an affiliated group which files consolidated Federal income tax returns, and its income is included in the consolidated returns. If United had not joined in the filing of consolidated returns, but had filed returns only reporting its income for tax computations, its net taxable income would have been fixed at a 52% rate. Because another of the affiliated companies, which is not subject to Federal Power Commission jurisdiction, sustained losses, the tax rate for the consolidated group is less than 52%.[1] United claimed that in fixing its rates, the Commission should allow as a part of cost of service the amount of income tax which it would have paid if it had filed a separate income tax return. The Commission disagreed. It allocated the tax differential between the 52% rate and the rate paid on the consolidated return, and allowed what it called an effective tax rate. The reasoning and conclusions of the Commission in *Re Cities Service Gas Co.*, 30 F.P.C. 158, 49 P.U.R. 3d 229, were followed by the Commission. The Commission, with two of the Commissioners dissenting, rejected the contention of United. *Re United Gas Pipe Line Company*, * * * F.P.C. * * *, 54 P.U.R. 3d 285.[2] United has petitioned for a review of the Commission's order. Texas Gas Transmission

[1] The 52% corporate tax rate referred to here and elsewhere is not strictly accurate as the first $25,000 of corporate income is taxed at a 22% rate.

[2] Subsequent rulings of the Commission, —— F.P.C. ——, 55 P.U.R. 3d 483, —— F.P.C. ——, 55 P.U.R. 3d 499, on rehearings do not affect its ruling on the issue before the Court.

Corporation and Texas Eastern Transmission Corporation, who are customers of United and intervenors in the proceeding before the Commission, have also petitioned for review, aligning themselves with United.[3]

The Court of Appeals for the Tenth Circuit vacated the Commission's order in the *Cities Service* case. *Cities Service Gas Co.* v. *Federal Power Commission*, 10th Cir. 1964, 337 F. 2d 97. United would have us follow the Tenth Circuit's *Cities Service* decision. The Commission says that the *Cities Service* case is to be distinguished because of fact differences. It urges that the Tenth Circuit decision is wrong and should not be followed. We do not think there are any such fact differences between Cities Service and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be

Vacated and set aside.

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[3] The Commission has suggested that these intervenors are not aggrieved by the order and hence have no standing to seek a review of the order. The Court's disposition of the cause makes unnecessary a determination of this question.

APPENDIX B

United States Court of Appeals for the Fifth Circuit
October Term, 1965
D.C. No. RP63–1

No. 21872

UNITED GAS PIPE LINE COMPANY, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

No. 21958

UNITED GAS PIPE LINE COMPANY, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

No. 22031

NATURAL GAS PIPE LINE COMPANY OF AMERICA, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

No. 22041

TEXAS EASTERN TRANSMISSION CORPORATION, PETITIONER
v.
FEDERAL POWER COMMISSION, RESPONDENT

PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL POWER COMMISSION

Before JONES, WISDOM and GEWIN, *Circuit Judges*

JUDGMENT

This cause came to be heard on the petitions of United Gas Pipe Line Company, Natural Gas Pipe

Line Company of America and Texas Eastern Transmission Corporation, for review of Orders of the Federal Power Commission, on the consolidated tax issue, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the Order of the Federal Power Commission in this cause be, and the same is hereby vacated and set aside in accordance with the opinion of this Court.

February 10, 1966.

Issued as Mandate: March 7, 1966.

EDWARD W. WADSWORTH,
U.S. Court of Appeals, Fifth Circuit.
By ——— ———,
Deputy.

APPENDIX C

United States Court of Appeals, Tenth Circuit

July Term—1964

No. 7538

Filed, United States Court of Appeals, Tenth Circuit, October 9, 1964.

CITIES SERVICE GAS COMPANY AND CITIES SERVICE COMPANY, PETITONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

ON PETITION TO REVIEW AN ORDER OF THE FEDERAL POWER COMMISSION

Harry S. Littman (Conrad C. Mount, Jack Werner, George H. Hill, Jr., Melvin Richter and Richard Littell with him on brief) for Petitioners.

Richard A. Solomon (Howard E. Wahrenbrock, Abraham R. Spalter and Cyril S. Wofsey with him on brief) for Respondent.

Before MURRAH, *Chief Judge, and* HILL, *Circuit Judge,* and ARRAJ, *District Judge*

MURRAH, *Chief Judge.*

In an order of the Federal Power Commission approving a settlement of the rates charged by Cities Service Gas Company for jurisdictional gas sales, the Commission reserved for future determination the Federal income tax allowance to be included in the cost of service underlying the approved settlement.

This appeal is from a final order of the Commission determining that sole issue.

The stipulated settlement included as a part of the cost of service a tax allowance based upon the statutory corporate income tax rate of 52 percent applied to the agreed taxable income of the Gas Company for the test year 1958. And, that amount would be routinely granted as a cost of service but for the Gas Company's participation in consolidated returns filed by its parent, Cities Service Company.

Having elected to file consolidated returns under Section 1501, 26 U.S.C., Cities Service was required by Section 1504, 26 U.S.C., to include all affiliates in which it owns 80 percent or more of the stock. Under the consolidated returns the total tax liability was less than it would have been if each subsidiary had filed separate returns. The reduction in the total tax liability resulted from offsetting the losses incurred by certain nonregulated affiliates against the taxable income of all other affiliates; and the Commission determined a tax allowance which reflected the so-called "tax savings" effected by the consolidated returns. The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company.

The Commission recognized the fundamental ratemaking principle which requires a separation of regulated and nonregulated profits and losses in the determination of the tax allowance. And see *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581; *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635. In obedience to this principle, the majority of

the Commission rejected its Staff's theory which determined the tax allowance by taking the ratio of the Gas Company's income to the total income of the profit-making companies and applying this percentage to the total tax liability. The Commission characterized this theory as possessing "a quality of artificiality and instability which renders it unsatisfactory for rate-making purposes."

The majority of the Commission also rejected the determinations and recommendations of its Examiner who discarded the Staff's theory in favor of the settlement allowance based upon the statutory 52 percent rate. The Examiner could find no authority to support the theory that "consumers of natural gas sold in interstate commerce should have the benefit of 'tax savings' derived from business losses of unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas."

Proceeding on the established premise that only actual costs—hence actual taxes—are properly includible in a rate base, a majority of the Commission held that the consolidated income tax liability is the "only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates," and that to accept the Gas Company's approach based upon the statutory 52 percent rate would have the effect of determining jurisdictional rates "on the basis of converting a hypothetical tax payment into a prudent operating expense."

To comply with the rate-making principal of separating regulated and nonregulated profits and losses, and in conformity with the equally controlling actual cost concept, the majority of the Commission devised a "method to be applied in computing the

Federal income taxes to be included in the cost of service of a regulated company where the company has joined in a consolidated tax return with affiliates * * * (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, if computed on a separate return basis."[1]

As the basis for the application of this formula, the majority first selected the consolidated returns filed for the years 1957, 1958 and 1959. After separating the affiliates into regulated and nonregulated groups, the Commission determined that during the pertinent period the nonregulated companies had no net taxable income and that no tax liability should therefore be assigned to that group. The total taxable income of the regulated affiliates, which included companies regulated by other Federal and State agencies,[2] was determined to be $61,652,662, of which the Gas Com-

[1] One Commissioner would have adopted the Staff's theory but reluctantly joined two Commissioners in applying the above-described method in order to form a working majority. The other two Commissioners dissented contending that the Examiner's recommendations should be adopted. The dissenters were of the opinion that "Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating nonutility enterprises beyond the Commission's jurisdiction."

[2] Included by the Commission in the so-called "regulated" group, in addition to the Gas Company, are Cities Service

pany's share was 67.93 percent. This percentage was then applied to the normalized consolidated tax liability of all affiliates, an average of $8,636,607 a year, to arrive at the tax allowance of $5,866,847. The stipulated settlement had provided for a tax allowance of $7,055,981 based upon the statutory rate of 52 percent of the net separate taxable income of the Gas Company in 1958. The difference between these two sums is the bone of contention.

We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52 percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion of the Gas Company in the consolidated return in-

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Pipe Line Co., and Lafitte Oil Traders, Inc., both subject to regulation by the Interstate Commerce Commission, and Kansas Gas Supply Company, subject to regulation by the Kansas Commission. Also included in this group is that portion of the income of Cities Service Gas Producing Co. and Cities Service Oil Co.—Delaware—subject to regulation by the Federal Power Commission. These companies, however, are primarily engaged in the wholly unregulated oil business.

creased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.

Similarly, in both 1958 and 1959 the inclusion of the Gas Company in the consolidated returns directly affected the consolidated tax liability in the amount of 52 percent of the Gas Company's taxable income, notwithstanding the fact that in those years the other Cities Service affiliates had aggregate tax losses. Application of the loss carry-back provisions of the Internal Revenue Code permit the offsetting of these losses against the taxable income of these affiliates in 1955 and 1956 [3], thereby resulting in tax refunds. No reduction in the actual total tax liability was thus effected since the net effect of the inclusion of the Gas Company in the 1958 and 1959 consolidated returns was to reduce the refund by 52 percent of the Gas Company's taxable income. See table below.[4] The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas company.

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[3] The regulations promulgated pursuant to § 1502, 26 U.S.C. provide in accordance with § 172, 26 U.S.C. that a net loss in any year can be carried back to the three preceding years or carried forward to the succeeding five years. 26 C.F.R. Part 1, § 1.1502-31(a)(4).

[4] See the following table:

Year	(1) Consolidated tax (including Gas Company)	(2) Consolidated tax (excluding Gas Company)	(3) Gas Company's separate tax	(4) Sum of (2) plus (3)
1957	$12,251,639	$6,391,241	$5,860,398	$12,251,639
1958	(3,857,132)	(10,224,666)	6,367,534	(3,857,132)
1959	2,965,014	(6,566,531)	9,531,545	2,965,014

We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. See: *Colorado Interstate Gas Co.* v. *F.P.C., supra; Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra; Wisconsin* v. *F.P.C.*, 373 U.S. 294. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C., supra,* p. 641.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.

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